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UNCLAS SECTION 01 OF 03 TEGUCIGALPA 000896

SIPDIS

SENSITIVE

STATE FOR WHA/CEN, WHA/ESPC, DRL/IL, AND EB/IFD/OMA
STATE PASS AID FOR LAC/CEN
STATE PASS USTR FOR ANDREA GASH DURKIN
TREASURY FOR JOHN JENKINS
DOL FOR ILAB

E.O. 12958: N/A
TAGS: PINR EFIN ETRD ECON ELAB HO
SUBJECT: C-AL3-00272: IMPORT DUTIES HAVE DECLINING IMPORTANCE IN HONDURAN CENTRAL GOVERNMENT BUDGET

REF: (a) STATE 76257

(b) TEGUCIGALPA 546 (c) TEGUCIGALPA 865
(d) TEGUCIGALPA 494
(e) TEGUCIGALPA 225
(f) TEGUCIGALPA 010

¶1. (SBU) Summary. Honduran trade liberalization over the past 13 years has resulted in a declining dependence on import duties and other taxes on international trade. In 2002, revenue from import duties had dropped to only 2.2 percent of GDP and an estimated 12.2 percent of total tax revenue (excluding taxes on oil products). The gap has been made up, primarily, by an increase in the sales tax rate. Given that about 55 percent of Honduran imports come from the United States, a CAFTA-related reduction in import duties would be significant but manageable for the government. There has been no discussion to date on the likely way of compensating for the revenue from CAFTA (or eventual FTAA) tariff reductions; measures are likely to involve elimination of remaining tax exemptions or a small increase in the sales tax rate. End Summary.

2.(SBU) Ref a requested reporting on the effect that a loss of tariff revenue would have on government budgets following the implementation of the U.S.-Central American free trade agreement (CAFTA). Reftels b through f provide extensive reporting on the 2003 budget (currently under substantial revision), the government's fiscal difficulties and efforts to confront them. In addition, a recent report by an IDB-funded team on Honduran tax policy provides useful historical data on the trends in customs duties receipts over the past 13 years that can be used to project the direct impact of tariff revenue losses, once the basic parameters of the CAFTA agreement are agreed. These data are provided below.

¶3. (SBU) Since the early 1990s, Honduras has transformed the structure of its taxation of trade. Export taxes have been eliminated, and substituted with export promotion policies (including the granting of extensive investment incentives such as tax exemptions). High tariff barriers to imports have been progressively dismantled in conjunction with other countries in the region and the Central American Common Market. As of 2002, Honduras had 5,982 eight-digit tariff schedule line items, of which 5,169 registered some imports. There were 13 tariff levels in the tariff schedule, with an average nominal rate of 6.5 percent (and a trade weighted average of 8.4 percent in 2000). Most tariffs are now between 0 and 15 percent. As of 2001, 73 percent of Honduras's tariff schedule was harmonized with the rest of Central America (and further harmonization was achieved in 2002). Tariff dispersion in 2002 was a relatively healthy 7.4 percent.

¶4. (SBU) Accordingly, customs duties in Honduras have dropped progressively since 1990 as a percentage of both GDP and total tax revenue. Import and export duties fell from 5.6 percent of GDP in 1990 to 2.5 percent of GDP in 2001 and an estimated 2.2 percent of GDP in 2002. Similarly, import and export taxes fell from 37.5 percent of total tax revenue in 1990 to only 15.2 percent in 2001 (and 12.2 percent of total tax revenue if oil import taxes are excluded). The lowering of customs duties in Honduras in the 1990s was accompanied by an increase in the sales tax rate to 12 percent for most products. As can be seen by the chart below, by 2000, sales tax revenues had replaced import duties as the most important source of government revenues.

Table 1
International Trade Tax Revenues

	1990	1995	2000	2001	2002
	(millions of nominal Lempira)				
Total trade	707.2	1607.2	2088.2	2448.1	2437.7
Imports	493.2	1429.5	2082.8	2448.1	2437.7

Oil	58.4	323.5	297.0	598.4	708.0
Other	434.8	1106.0	1785.8	1849.7	1729.7
Exports	214.0	177.7	5.4	0.0	0.0
		(percent of GDP)			
Total Trade	5.6	4.3	2.4	2.5	2.2
Imports	3.9	2.8	2.4	2.5	2.2
Oil	0.5	0.9	0.3	0.6	0.6
Other	3.5	2.9	2.0	1.9	1.6
Exports	1.7	0.5	0.0	0.0	0.0
		(percent of tax revenue)			
Total Taxes	100.0	100.0	100.0	100.0	100.0
Income	22.8	28.5	19.9	22.0	22.7
Property	0.8	0.8	1.3	1.1	1.0
Cap.Gains	0.0	0.6	0.5	0.3	0.0
Sales	18.2	20.6	35.2	33.2	35.2
Selective	13.4	15.1	11.2	12.0	10.9
Services	4.8	3.8	17.6	16.2	17.6
Trade	37.5	24.8	14.3	15.2	12.5
Other	2.4	5.8	0.0	0.0	0.0

¶5. (SBU) Revenue projections from the GOH's 2003 Central Government budget are shown below. These numbers are expected to change significantly as a result of the adoption of new tax measures on April 2 (see ref b). The GOH hopes that these measures will add as much as 2 billion lempiras (usd 118 million) to the budget in 2003 and 3.5 billion lempiras (usd 206 million) in 2004 and thereafter.

Table 2
Central Government Revenue Projections
2003 Budget

	Millions lempira	Pct of Total
Total Revenue	32944.0	100.0
Tax Revenue	19803.0	60.0
Income Tax	4315.0	13.0
Property Tax	212.0	.6
Sales and Consumption	9267.0	28.0
Services	3357.7	10.0
Import Duties	2608.0	8.0
Other	44.0	0.0
Non-Tax Revenue	1163.0	3.5
Goods and Services	16.0	0.0
Property Income	79.0	0.2
Aid and Donations	1447.0	4.5
Capital Revenues	3445.0	10.5
Financing	6988.0	21.0

¶6. (SBU) Approximately 55 percent of Honduran imports come from the United States. Thus, the reduction in import duties on imports from the United States expected after CAFTA would be a significant revenue reduction during this period of high deficits; however, it would be manageable. A very rough estimate would indicate a revenue loss of about usd 80 million per year if all tariffs were eliminated immediately. During 2002 and 2003, the government has attempted to offset the continued reduction in customs duties receipts with measures aimed at broadening the tax base (reducing exemptions from income and sales tax). There has been no discussion to date on the likely way of compensating for CAFTA (or eventual FTAA) tariff reductions. It is possible that the GOH would propose an increase in the sales tax rate.

¶7. (SBU) Comment: The IDB consultants, in a February briefing for Econcouns and USAID economist, also noted their belief that in addition to the reduction in customs duty revenue, the trade liberalization in the CAFTA agreement will provoke additional GOH spending or tax breaks as "compensation" to sectors negatively affected by increased competition. This is a possibility, as the Honduran Congress has consistently shown its willingness to enact special legislation for individual sectors. However, the current critical fiscal problems and the likelihood of fairly strict fiscal targets in a future IMF agreement will probably limit the GOH's ability to provide trade adjustment assistance to companies or individuals. On the plus side, the positive impacts from a free trade agreement -- increased investment, faster growth, and increased efficiency -- are expected to result in increased (non-tariff) government revenues as well. As noted above, the GOH also traditionally has provided significant export promotion incentives in the form of exemptions from a range of taxes. To the extent that the GOH agrees in the course of the CAFTA negotiations to reduce some of these investment incentives, this would also have a positive effect on the government's tax revenues. End Comment.
PALMER